RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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July 18, 1980 **LETTER 787**

July 3, DJIA 881.83; PTI 1252; A-D ratio –18.34
July 10, DJIA 891.13; PTI 1258; A-D ratio –18.01

THE PICTURE: Well, I just scrapped a fully-printed 6-page Letter–because I didn't get to the crux of what is bothering me about this whole picture. The fact is that the forces of inflation are running into a very sticky recession. I don't like to conjure up scenarios for the economy and then wait to see whether the economy and the markets follow my scenario. Rather, I like to follow the markets themselves, and then see if I can decipher what the markets are telling me.

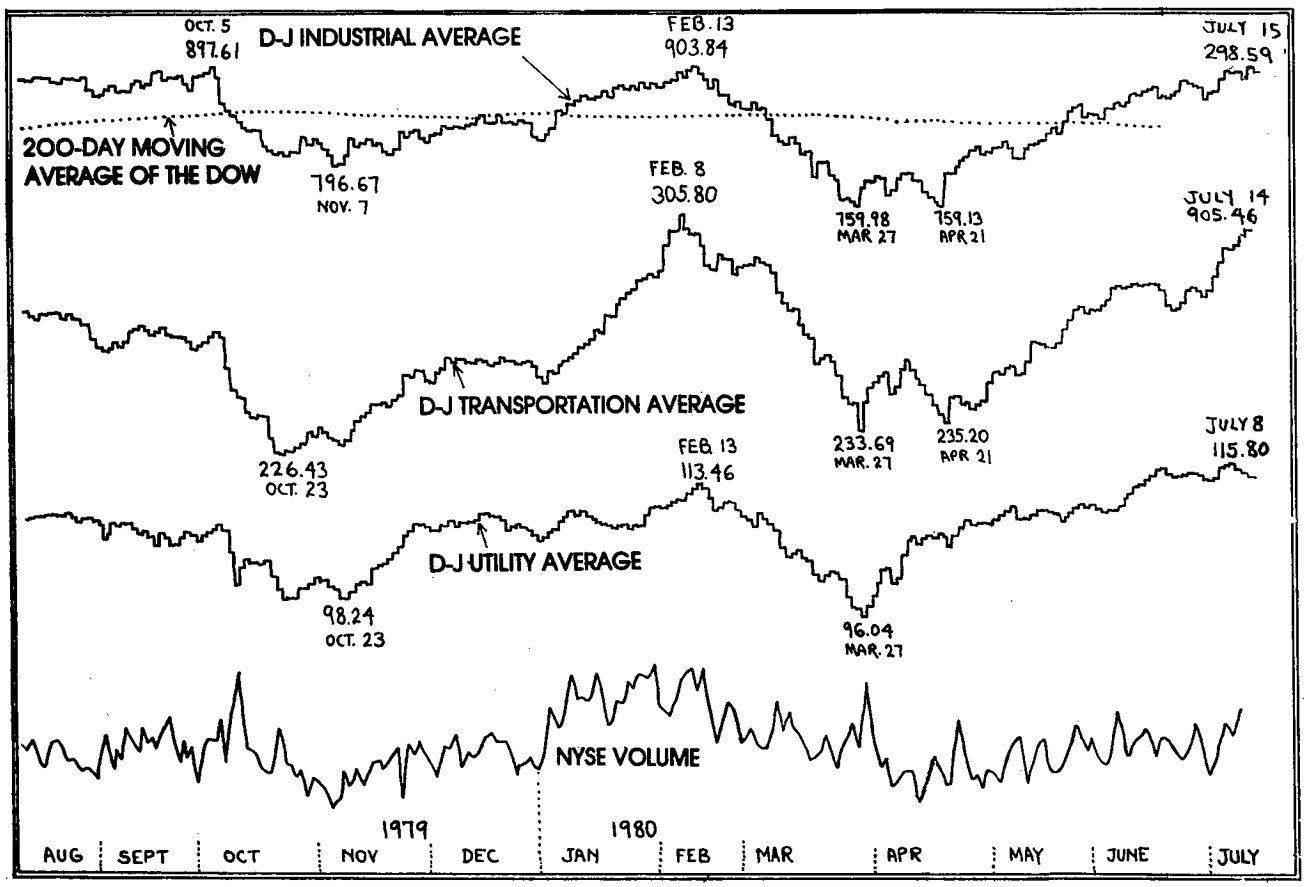
The inflation thesis is widespread. Most of the reports I read deal with virulent inflation and what to do about it. And I must say that I have pretty much agreed with the inflation argument. But now I want to stop, look and listen. And the question that taps on my brain is this: "For about three years the Administration and most of the analysts have been waiting for 'the recession'. " Now it is here, and all the analysts are predicting that it will go away "by the third quarter," by "year-end," "by early 1981." But suppose all of the analysts are wrong? Suppose the recession won't go away? Suppose the picture remains nasty, and the public stays skittish about buying; and the rest of the nations of the world, one by one, join the US in its recession?

So what I'm saying is that I know some very smart people who are saying that "we're on the way to more inflation and then hyper-inflation." And I know a few highly intelligent people who are talking "deflation and collapse." Which team is going to be proven correct? We've been in an inflationary environment for 20 years, and the odds always favor the prevailing trend continuing. But there is no doubt about it–deflation is a possibility! And it is that dilemma that the markets (I feel) are wrestling with now.

The chart below tells the story–at least up to this point. On July 14 the Industrials shot above their old February 13 high of 903.84–to record a new recovery high of 905.46. The Transports closed (Feb. 15) at 298.59, 8 points below their comparable February 8 high. Thus a definite non-confirmation exists, and it will remain in effect unless Transports can hurdle the 305.80 level.

From the standpoint of Dow's Theory, the action of the last four months does not prove anything about the primary trend of the market. If Transports better 305.80 (with Industrials moving in the same direction), we will certainly have something that looks like a primary bull signal. Lacking such a signal, however, anything can happen (particularly on a 61-million share day such as the one we witnessed July 15 when Industrials pushed to a new intra-day high, then sold off to close down 4 points.)

The March to July market action possessed a stubborn strength that was impressive. This persistent upside action stirred up a lot of excitement and much volume. However, at this point I feel that caution is warranted–and for the following reasons:



First, as stated, the Industrials pushed above their previous high, but the market then faltered in that area. It is wel to remember that this area (900 on the Dow) is the zone that has turned the market back on many previous occasions.

Second, we are now within two or three weeks of my projected August cycle top (i.e., the top of the 233-day cycle as outlined in the last Letter).

Third, the odd-lot transactions (10-day moving average of daily odd-lot sales divided by odd-lot purchases) hit a selling peak of 247 on July 1 (i.e., 247 shares sold for every 100 shares purchased). Since then, the 10-day average has been moving down. This means that the public or odd-lotter is losing his fear of higher prices, and he is cutting back on his selling. When this occurs, it is a sign of technical deterioration.

The chart below of the Dow, the Primary Trend Index and the advance-decline ratio paints a most interesting picture. Note that while the PTI has pushed strongly into new high territory, the A-D ratio is lagging. The A-D ratio is a proxy for all the stocks on the NYSE, and since March (even with the help of collapsing interest rates which bullishly and directly affect at least half the stocks on the NYSE) the A-D has not been able to better its February peak (at least as of this writing).

The PTI is my own proprietary indicator. It is computed (daily) from the action of 8 critical market indices and indicators, and it therefore cannot be manipulated by strength or weakness in one or two atypical-acting indices.

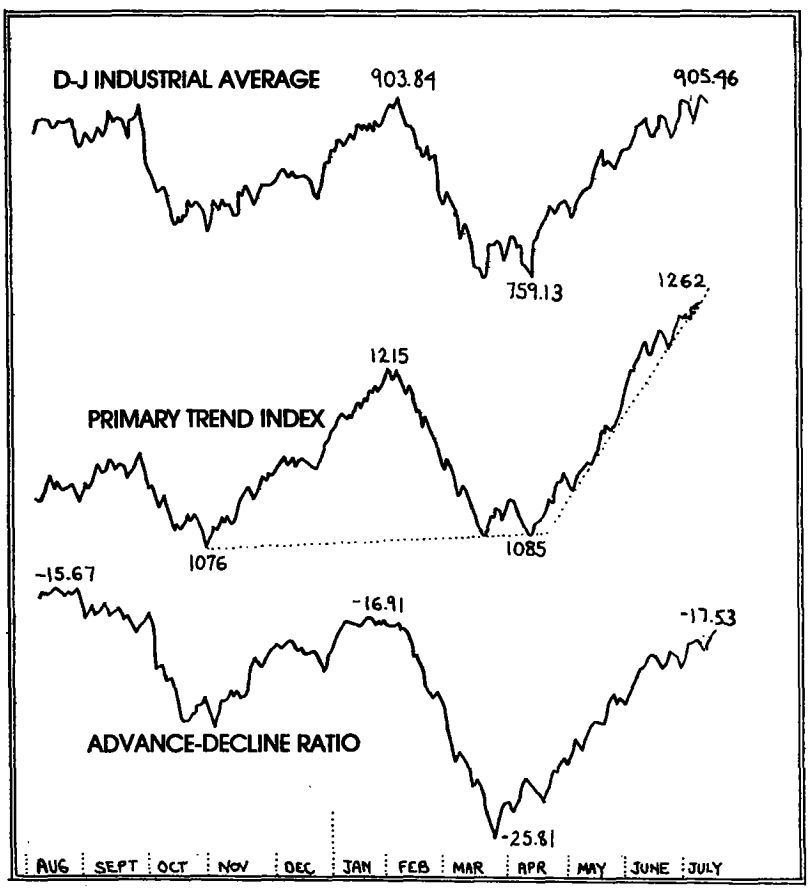
As of now, the PTI has climbed to a new recovery high. Note that the PTI has been walking up a steep trendline, and it has so far held above that trendline. The first hint of danger from the PTI, therefore, would be a breaking of the April to July trendline. It would not take more than two bad down days to do just that. But why jump the gun–it hasn't happened yet.

INFLATE OR DIE: I've used this expression over and over again. This nation is now literally drowning in debt. It cannot afford to contract. The Fed tried two months of contraction, only to watch the economy start to fall apart at the seams. Now the Fed and the Administration are literally begging the American people to buy, borrow, spend. They are doing handsprings in an effort to get people to go out there and "buy their heads off again." I don't know whether the public is going to drink the new debt-water. They've been led back to the debt-trough–but there isn't an economist or anlayst alive who can know for sure whether the public will drink!

I have said before, and I repeat–I believe the Fed is terrified at the thought of deflation. The Fed doesn't like inflation, they would like to slow it down–but deflation–it makes their blood run cold.

Along these lines, I thought the following interview by my friend, Neland Nobel of North American Coin & Currency Ltd. (34 W. Monroe, Phoenix, AZ 85003) was well worth inserting. Why did the Fed want these fantastic rulings put into law? Why did they want the power to inflate with nothing to stop them? There is only one reason I can think of–the Fed is mortally afraid of a situation where they might lose control to for forces of deflation and depression.

For as night follows day, deflation must follow inflation. The Fed has decided that it cannot let that happen. It can not let America's debt eat the nation alive. And the only way to keep a mountain of compounding debt afloat is via the inflation route. So read this interview, and learn what is on the mind of Mr. Volcker and the people at the Fed.



SPECIAL INTERVIEW WITH CONGRESSMAN RON PAUL

On March 27th, the Monetary Control Act of 1980 passed the House of Representatives by a vote of 380 to 13. The next day, it passed the Senate by voice vote. We feel this legislation will stand as one of the most important monetary acts since the creation of the Federal Reserve Act of 1914.

Almost alone in his opposition to this very important legislation was Congressman Ron Paul of Texas. Congressman Paul remains one of the few hard money advocates on the Hill and we are very pleased that our interview is with this courageous conservative. By the way, if you would like more information about his work or would like to assist him in his re-election (he has lost twice by extremely narrow margins), you can write to him at Box 602, Lake Jackson, TX 77566. (Mr. Neland Nobel interviewed Mr. Paul on June 17th)

NACC - What are the basic provisions of the Monetary Control Act of 1980?

PAUL - That's a very complex bill. It was tacked on to the Depository Institutions Deregulation and Monetary Control Act, which had parts that were very decent. But the Monetary Control Act was mainly a bill directed toward preserving members in the Federal Reserve System. The main effects from this have been that they've essentially eliminated the question of membership and everybody has now been put under the F.R.S. They've coordinated all the depository institutions to the Fed. This is very significant because it's taken the number of banks under their direct control from 5000 to over 15,000, and each one will have access to the Fed's discount windows.

NACC - Weren't there changes in the reserve requirements?

PAUL - Yes. In each category, the reserve requirements were reduced. You have to take this in the context of what you hear and what the Fed is doing. Now, the Fed has a tight-money policy, yet they're passing a bill that actually lowers reserve requirements. The thing that disturbed me most about the bill was that the Fed, if it decides it wants a broader range of reserve requirements (now about 6-8% with the new bill) can suspend all of these rules for a period of 180 days on their own. They can do this anytime thay want to. They can suspend all the reserve requirements and either raise or lower them...even to zero percent. I talked to Mr. Volcker twice about this issue. First, he indicated that the Fed would raise requirements with the new powers. But then he admitted that there were some areas where he would like to suspend all reserve requirements. So, I think what they say they will do is a little different than what they plan to do with this new legislation.

NACC - Didn't the Act change the definition of the collateral the Fed can now hold?

PAUL - They've expanded the definition of collateral to include any asset the Fed can purchase in their open market operations. That is a wide open definition!

NACC - Would it be possible for the Fed to buy Chrysler Bonds, for example, and use them as collateral?

PAUL - In my opinion, yes. And other economists agree with me in that interpretation.

NACC - One thing that has prevented local governments from going on a spending spree was that they could not monetize their debts. But doesn't this new law remove that obstacle to inflation?

PAUL - Yes. They can now monetize their local debt by way of the back door. They just send their municipal bonds, etc., over to the Fed who uses them as collateral and issues Federal Reserve Notes for them. Also, it's important to recognize that for the first time they've eliminated the collateral requirement for the Federal Reserve Notes stored in member banks. Before the new bill, a member bank had to have collateral on deposit in order to get additional Federal Reserve Notes. But now, the Fed can print unlimited quantities of Federal Reserve Notes for storage. Many have argued in the past that in this country we can still have deflation because we've got a credit inflation rather than a currency inflation. But in my estimation the Fed has the vehicle now to create a currency inflation as well, a power they want in order to hold things together.

NACC - How can such an important bill...one with such wide ranging ramifications for the whole country.... get through Congress with such little fanfare?

PAUL - It slipped through the way most of the legislation slips through...rather haphazzardly and deceitfully. This bill came up several times as a separate bill, had trouble, and on the third version it was noticed that a new paragraph had been added, namely the one about changing the definition of collateral. It was then removed without any hesitancy when it was brought to the attention of House members. (It seemed to me that they didn't want to discuss it, because they weren't afraid of me in any way as I don't have any particular legislative clout.) But then it went to the Banking Committee of the Senate where the Fed insisted the paragraph be reinstated. Then it went to the Conference Committee and the new paragraph was back in, but no one was saying anything about it. The bill then had three other bills tacked on it, bills that were major pieces of legislation and that were pretty beneficial. It was these latter portions of the overall bill that were emphasized, and so, members (who had a very superficial understanding of the bill) lent their whole-hearted support to the whole thing. So, it was a tremendous little coup for the establishment to put these things into the bill without the members knowing about it.

When I brought up the question of the definition of collateral at the Banking Committee, the author of the bill appeared very unaware of it and referred it to staff, who I'm sure put it in under the direction of the Treasury or the Fed. And the member, himself, probably wasn't even aware of it going in. Then the bill came to the floor and passed overwhelmingly. I was the only member who spoke against the monetary portion, mainly because the other parts had such political significance, members knew they had to pass it & it was popularly accepted by the people, so, we had a total of only 13 people vote against it. Rather scary!

NACC - Given the worst possible recessionary scenario, do you think it's possible for even a Ronald Reagan to resist the temptation to reflate?

PAUL - No. I think he'd have to reflate. but I am not sure that if he didn't reflate that there would be the dark consequences everyone supposes. There was a deflationary period following WW - II where we reduced the budget 75% in just four years and even created a surplus. Yet we created jobs, unemployment stayed low and prices seemed to moderate.

But if we go back to deflation and don't de-regulate and de-tax, I think we'll have a terrible tragedy. We must create the climate in which businessmen will be able to produce again.

GOLD & MONETARY NOTES: Mining of new gold runs about 1300 tons per year (this includes all production, Russia and S.Africa and North America). This amount of production has held since the 1970's. But suddenly, we have a mystery. Nobody wants to sell gold. The IMF has ended its gold sales. The US has halted its monthly auctions. Russia has sold little gold this year. South Africa has cut back gold sales and announces that it will use gold cut-offs as a matter of policy in the future in order to "stabilize gold." Total gold supplies to the West in 1980 are slated to drop 43%.

Then we have the case of four nations that have just called in large amounts of gold (out of the London banks and into their respective coffers). This is unusual, because for trading purposes it is far more convenient to hold gold in the West, but Iran, Libya, Indonesia, and Nigeria have just called in tens of tons of gold. What's happening? The July 2 WSJ quoted a New York based trader as follows: "*When gold is in London it's easy to sell. If they're moving it to the Middle East, it means they intend to hang onto it indefinitely.*"

On top of this, the June 7th NY Times noted that Russia sold 200 tons of gold to the Saudis ($600 an ounce). This suggests that the Arabs have finally perfected a plan through which they can protect themselves against a declining dollar. How does the plan work? Easy, you sell (or barter) oil for gold. Then you raise the price of oil (which puts upward pressure on gold), and lo, you have profits which offset the declining value of your dollars.

* *

Official world monetary reserves at the end of 1979 were $320 billion in foreign exchange (this against $100 billion in 1972), $470 billion in gold (at gold valued at $500), IMF reserve position of $15 billion and $16 billion of SDR or Special Drawing Rights. Of the total foreign exchange, 75 to 80% is in dollars, the rest is Deutschemarks (11%), Swiss francs (about 5%), and Japanese yen about 4%. The big worry among central bankers is that $320 billion in dollars, and most nations are now pursuing a policy of slowly diversifying out of dollars.

Of interest is where these nations are diversifying. One statistic is indicative. The dollar and the Swiss franc are now at about where they were (in relationship to each other) at the beginning of 1980. But gold is about 25% higher in terms of both dollar and francs (and the franc is tied to the German mark). The con-

clusion is obvious. All paper has been declining in terms of gold. Implication: somebody has been swapping a lot of paper for a lot of gold!

* *

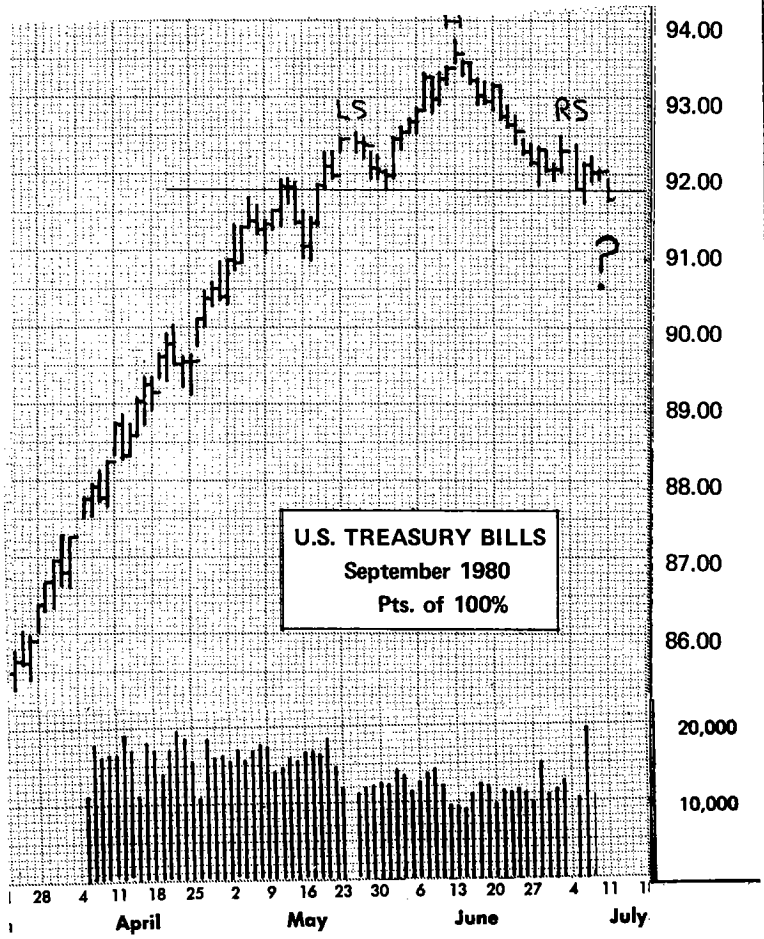
Current top record on the US hit parade is a song by rock star Bob Seegar called "Fire Lake". If the US Government ever writes a song, it will be called "Debt Mountain." These latest statistics show you where your Government is on the mountain. Total Federal deficits are now approaching $900 billion. And the **cost of servicing** the debt is going to hit $70 billion this year for the first time (that's at the rate of $1.34 billion each week!). For comparisons, in 1929 the entire US Federal debt was $16 billion. There's only one thing that supports this kind of compounding of debt—rising inflation!

Government Finances

WASHINGTON (AP) — Here are the figures on government spending and debt (last six digits are omitted). The government's fiscal year runs from Oct. 1 through Sept. 30.

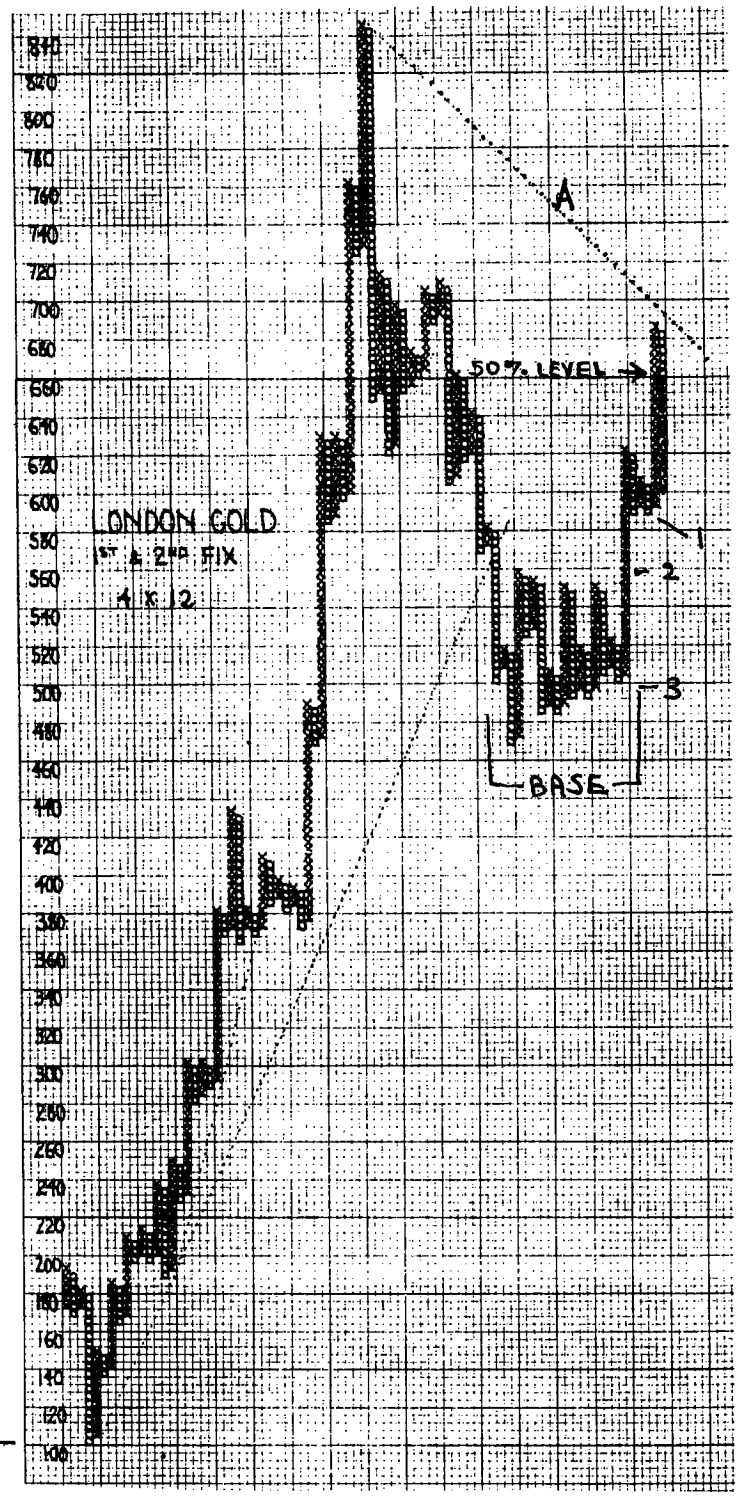
Total public debt as of July 7	873,386
Interest on public debt for May	5,837 ←
Interest for fscl yr. thru May	47,415
Estimated budget deficit fscl 1980	36,506
Actual budget deficit last year	27,700
Receipts for fscl yr thru May	325,844
Receipts for same period last yr	292,122
Outlays for fiscal year thru May	381,856
Outlays same period last year	328,154
Budget deficit through May	56,011 ←
Budget deficit same period lst yr	36,033
Gold for May	11,172

RATES: This chart now assumes great importance! What we see here is an important head-and-shoulders top in the T-bill futures (chart courtesy of Dunn & Hargitt, 22 N. 2nd St., Lafayette, In 47902). The T-bills have hit their price peak and are now headed down. Since T-bill yields move inversely to their price, the implications are that short-term (and, in fact ALL interest rates) are headed higher.



My advice: if you are in any money instruments longer than 91-day, it's "bye bye time." Sell them and move into T-bills. The top has been formed and the next move should be to a sharp jump in rates. If that occurs, I don't think the stock market is going to like it.

GOLD ACTION: In the last Letter I discussed the significance of the 662 or halfway level of the 1980 gold correction (i.e., the correction from 850 to 474). I stated that if gold can push above 662 and then hold decisively above this level, the 50% Principle would be bullishly activated. The 50% Principle says that following an extended decline, if the price movement turns up and consolidates above the 50% level of that decline, then probabilities favor an ultimate return to and test of the old highs (all in due time, of course).



On July 3 London gold pushed above the 662 level. It held above 662 for 5 days. But unfortunately, it couldn't hold above that magic level. That's discouraging for gold bulls–but all is not lost.

Please study the accompanying point & figure chart of London gold (all rallies or declines of 12 points or more are shown, and each box represents 4 points). Let's follow the recent action. Gold came out of its large base in the 474 to 560 area. It then surged up to the 688 level and into the resistance area. The resistance is delineated by descending trendline A. Gold halted its ascent just below the resistance trendline, which comes in at approximately 700. From there gold sank. The drop has been precipitous and scary. And clearly the question on the mind of gold holders is, "Can this be another 1974–or even another early-1980?"

In all honesty, I don't have the answer to that one–and neither does anyone else. From the bullish viewpoint, it could well be that gold is forming an immense "head-and-shoulders bottom" with all the recent action constituting the right shoulder (in that case, the horizontal line marked A on the chart would be the target to surmount.) If that is the case, then gold should hold (spot) above the 580 level, and ideally above the 600 level. But the markets are spiteful, and often maddening, and if gold is out to "drive us all up the wall" it will probably sink into its base again.

At any rate, if the inflation thesis is correct, gold "should hold" above its original 560 breakout level. But what, you ask, what if gold starts folding and breaks back into its base again? In that case, I'd say, "Discouraging, but all is not lost." However, this could be a time to be very careful about gold holdings. I never like to carry a position in anything that I can't handle, and by handle I mean that I can't sleep with. And gold is no exception.

I've told readers that I don't like futures trading, and I particularly don't like gold futures. Gold is real money, money with no mortgage against it. But when they put gold into the blasted futures market, they placed a fat debt against gold and made it a speculative item just like cocoa or hogs. This should never have been allowed to happen (I know the Swiss were violently against gold futures), but it did happen, and it's made gold a volatile item.

What are the points to watch on gold? I would start to lighten up if gold breaks below 592 (point 1 on the chart, p. 4). I would lighten up more on gold if it breaks below 560 (point 2 on chart). I would get super-light if gold breaks below 500 (point 3). I can't make markets but I sure can listen to them. I hope the whole gold structure holds together, but if it does not, then learn to let the market itself be your guide. NEVER trust to luck, NEVER trust some expert's private opinion, NEVER trust your intuition above the action of the market itself.

Nature and the exchanges are kind enough to provide two very good danger signals. Nature's danger signal is flashing when you can't sleep. The exchange's signal is flashing when you get a margin call. Never ignore either of these signals. They are telling you that something is wrong, and the prescription is summed up in one word, "Sell."

Some subscribers may think that Richard Russell (or some other analyst) has some kind of pipe-line to the truth–or perhaps some 6th or 7th sense about the market. I know a lot of talented men and women in this business, but none of them have the final truth about what's going on on Wall Street. We have flashes of truth, we have insights, we make an occasional good call, but in general a stock market analyst is just a guy with a large ego and the willingness to make statements that most sane men and women wouldn't dare make.

Robert Rhea, the great Dow Theorist of the 1930's, once wrote that "The more cock-sure the analyst, the bigger the quack." I couldn't agree more. I've never seen a cock-sure soothsayer in this business who didn't ultimately fall on his pratt. And the bigger the following he had at the time of his greatest "forecast," the more people he took with him when he finally dropped off the edge.

In this business, you've got to do a lot of your own thinking, a lot of your own studying. Nobody else can really do it for you. It's a tough business and the first thing you have to learn is that there are times when you are going to be wrong. And being wrong is OK. But remember this and maybe put it in a frame over your desk. The crowning sin in investing is not being wrong, IT'S STAYING WRONG! And that's all I have to say for this session.

FINAL THOUGHTS: I re-wrote this whole Letter, and I don't know yet whether it will be 5 pages or 6. I do know that it will be late in arriving, and I'm sorry but that couldn't be helped (since I had to scrap the one I originally wrote).

But I want to say one final thing about the markets. If, and I say IF, the stock market should turn down and if gold continues to go down, it will look suspiciously to me as though the inflation arguments are about to blow up. By that I mean that if gold and the market start falling out of bed (i.e., gold below 500 and the Averages below their March, 1980 lows), then I would think that deflation was beginning to take over. The odds are against that happening, but I've always said that ultimately we will have to pay for our two-decade inflation party, and we will pay for it–with deflation and bankruptcies–it's a question of **when**.

What would be the ideal position if gold and the stock market start unravelling and deflation takes over? My own thought is (at least in the beginning of the move) mostly cash or T-bills and some gold. Why the gold? Because I think there could be terrible problems in the banks and in the whole banking system if deflation ever rears its head. If that happens, the viability of the monetary system itself would come into question. And then there would be only one final monetary refuge–gold itself.

RATES: Please note again that rates for these Letters will be going to $185 per year, $105 for six months–to be in effect August 1, 1980. However, I will accept one or two year **extensions** to your current subscription at the old price of $150–if those extensions are mailed by August 1. Thank you.

On page 6 is a piece I just clipped out of the Los Angeles Times. I thought it was very interesting and rather ominous. When you read it you'll understand why Carter is backing away from a tax

cut. With the deficit that is now emerging, a $25 to $30 billion tax cut would run the deficit well over $100 billion. Yet without a tax cut, it may be difficult to turn this economy around. So there it is, the noose grows ever tighter.

WASHINGTON—Carter Administration officials now fear the budget deficit for this fiscal year will be close to $60 billion, possibly foreshadowing another rise in interest rates, informed sources said Friday.

President Carter's top economic advisers are now working on the formal estimates on spending and revenues that will be presented to Congress on July 21 in the midyear economic review.

Experts inside the Administration said the red-ink figure for the fiscal year ending Sept. 30 will clearly be viewed with alarm in the nation's financial markets.

"It could go to $60 billion," said one official, who asked not to be identified. "There's no question that it's going to be way above $50 billion."

If the July 21 forecast for this fiscal year comes close to $60 billion, officials said, it could trigger a change in money-market psychology and start interest rates rising again after their recent swift decline.

When the government spends more money than it takes in from taxes and other sources of revenue, it must borrow to make up the difference. Bigger-than-expected Treasury borrowing will be required this summer, officials said, because of the depressed conditions and it may have harmful effects on the anti-inflation campaign.

Many economists believe there is at least some relationship between the size of the federal deficit and increases in the general level of prices as the government prints more money to pay for additional borrowing.

Normally, most attention would be focused on the President's projections for unemployment and inflation when he sends the midyear economic report to Congress.

This year, however, the unusually large deficit is expected to take the limelight.

"It's going to be eye-popping," one official said of the deficit.

The chorus in favor of building up the US military is reaching crescendo proportions. Forbes and Newsweek have just run cover stories on the sad state of our military. Here's the interesting wind-up of the Forbes piece.

In an article that so clearly advocates rearmament as this one does, it is only fair to ask: Okay, but how much will it cost? Shortages of skilled manpower and equipment problems are by no means confined to the Navy. The Congress has already formally put the price of maintaining the U.S. military with some buildup at $1 trillion over the next five years. That only includes part of the *extra* $100 billion for the Navy. Even that $1 trillion could grow, depending on what happens to controversial proposals like the MX missile, the B-1 bomber, the CX air transport and big pay hikes for all the services. So there it is: upward of $50 billion a year on top of the current military budget of $150 billion. What does that do to hopes for a balanced budget? It plays hell with them, but consider the alternative. The Soviets read the proper lessons from the Cuban missile crisis and acted upon them. We did not. Now we are going to have to pay for that complacency. ■

My old friend Eliot Janeway has been on a "winning streak" for quite some time now. While most analysts and economists have been waving their hands in the dark, Janeway zero'd in on gold and gold shares and scored bullseye after bullseye. To put it mildly, he's been "hot." In his June 25 Janeway Letter (15 E. 80th St., NYC 10021), Eliot writes, "*Now an explosive crisis cycle expansion in military spending is again about to reverse an apparent business cycle slump–this time more violently than during the Korean War emergency of 1950 . . . . It will be 'hyperinflatonary', instead of merely inflationary; its momentum will be good for a decade, not just for a 3-year spurt like Korea*"

Janeway then goes into the methods of defense contractor financing and states, "*To finance these long-load-time, multi-billion dollar procurement awards and order backlogs during emergency cycle expansions, the contractors first go to the banks and then to the capital markets. But this year's splash of budgetary red ink will run over $100 billion–before any emergency arms spending program inflates it into the stratosphere..... Public sector borrowing will determine the direction of activity and inflation in the economy in the early 1980's. They are headed explosively upwards. Politically, though the voters are against inflation, they are for the rearmament that fuels it, and they will welcome the borrowing binge and buying boom that is coming with it.*"

NEXT MAILING: July 30th